

# Credit Markets 2014-2015

Analysis and opinions on credit markets  
Issue 2



Building a better  
working world



01	<b>Foreword</b>	16	<b>UK secured real estate lending</b>
02	<b>Meet the Partners</b>	18	<b>Regional debt markets</b>
04	<b>Big themes for 2014-2015</b> Economic forecast in summary Business implications in summary	19	<b>Sector moves to centre stage</b>
06	<b>Leveraged finance: powering on</b> Leveraged Loan markets High Yield Bond market Debt Fund market	20	<b>Asset-based lending</b>
08	<b>Investment Grade</b> Loan markets Bond markets	22	<b>IPO</b>
12	<b>Volatility and uncertainty push hedging to the fore</b>	24	<b>About Capital &amp; Debt Advisory</b>
14	<b>Default rates are falling for speculative grade companies</b>	25	<b>Our London and Manchester Capital &amp; Debt Advisory team</b>
		26	<b>Meet your global team</b>
		27	<b>Thank you</b>
		28	<b>Data centre</b>
		32	<b>Further insights</b>

# Contents

# Foreword



## Welcome to our second issue of *Credit Markets*.

We would like to thank those clients, colleagues, lenders and other market participants who provided feedback to the team about Issue 1. Your comments have played an important role in guiding the content of Issue 2.

2014 was, without doubt, another great year for credit markets. The year's performance was supported by solid credit fundamentals, continuing support from stimulus mechanisms from our central banks and regulators and an apparent acceptance of the new world post-recession. Competitive tension between lender pools led to a beneficial environment for borrowers across credit spectrums and quantum. Margin compression and then covenant flexibility led to the best credit market conditions since 2007. To call out a couple of themes, 2014 was the year of the amend and extend transaction (with borrowers taking advantage of the reduced margins becoming available) and we also saw the debt funds taking significant market share. At the time of writing, the High Yield Bond markets are seeing significant outflows and issuers pulling their transactions in a stampede back to the banks.

We remain excited about 2015. We expect to see further innovation in the credit markets, new market entrants improving liquidity, continued activity in the capital markets and, finally, bulging corporate acquisition pipelines starting to deliver deal flow.

2014 was also another important year for our Debt Advisory platform. We now have a UK team of 30 advisers and a global team of 70, and have opened offices in China and the UAE. Our connections to global capital pools are stronger than ever. We have also set up our Hedging Advisory desk and further invested in our Credit Ratings Advisory desk.

Finally, I would like to say that it was an easy decision for our Partner team to continue with the publication and we are again delighted with the content, drafted by the team and with little interference from Luke, Gary or myself. So a thank you to the team, too, and also to those involved in the production of *Credit Markets*.

We look forward to talking to you about credit markets in 2015. Best wishes for the New Year.

**Chris Lowe** Partner, EY and Editor of *Credit Markets*

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# Meet the Partners

## Chris Lowe

Chris joined EY from Citigroup in 2009 and became a Partner in 2012. He lives in Winchester, commuting daily into London Waterloo. When not debt advising he spends time with his wife, children and friends. Other interests, when he can squeeze them in, are skiing and motorsport. His focus within Debt Advisory is largely on crossover credit and leveraged finance.

## Luke Reeve

Luke joined EY from HSBC's Global Capital Markets division in 2009 and became a Partner in 2012. He lives in Clapham with his wife Fleur and their two children, Max and Sixtine. Away from the office he spends weekends in the Oxfordshire countryside and enjoys skiing, tennis, riding, dog-walking and playing football. Luke is responsible for the Investment Grade and Corporate market segment of Debt Advisory.

## Gary Davison

Gary joined EY in 2007 and has been a Partner for over 5 years. An experienced banker, Gary's work in Debt Advisory focuses on the regional corporate, structured finance and financial services markets. Gary lives in Worsley with wife Jude and their children Callum, Becky and Sam. Away from the office he spends a lot of time in their house in Mallorca, as well as watching the exciting redevelopment of Manchester United.

## K.C. Brechnitz

K.C. is Global Head of Capital & Debt Advisory. He joined EY in 2010 after spending 11 years with Banc of America Securities and Wachovia Securities, working in leveraged finance, high yield capital markets and restructuring. At EY he focuses on advising clients in connection with raising capital for acquisitions, recapitalisations, growth projects and refinancings. K.C. lives in Charlotte, North Carolina with his wife and their three children. He enjoys competitive cycling, hiking, and coaching youth sports.



Clockwise, from top left:  
**Chris Lowe, Gary Davison,  
K.C. Brechnitz and  
Luke Reeve**





# Big themes for 2014–2015

## Uncertainty returns – but inflation stays at bay

### Economic forecast in summary

In the first half of 2014 the UK economy hit the 'sweet spot', with the beneficial effects of rising investment and confidence feeding through. But while growth is set to continue, the outlook is now clouded by a growing groundswell of risks.

On the positive side, our headline projections for UK GDP still look reasonably healthy. We're forecasting growth of 3.1% this year and 2.4% next, with interest rates on hold until the spring of 2015.

But, as we noted in our recent special report, consumer spending remains subdued by falling real wages – a situation that has helped to keep inflation at bay. With falling global commodity prices helping to keep input prices down, we expect CPI inflation to slow to an average of just 1.3% in 2015, and to stay below 2% until 2017.


Subdued consumer spending has also seen business investment take over as the engine of recovery. Capital spending accounted for almost half the rise in GDP in the past year.

However, as political and economic risks and uncertainties multiply – ranging from the UK general election to the Eurozone's slowdown to the situation in the Ukraine – this engine is now under threat.

Recently, the UK economy has surprised on the upside. It might again. But currently, the balance of risks is downwards.

By **Peter Spencer**, *Chief Economic Adviser, EY ITEM Club*

Extracted from *Economics for business, Uncertainty returns – but inflation stays at bay*, UK Economic Forecast, Issue 70, Autumn 2014, Ernst & Young LLP, 2014.



"... while growth is set to continue, the outlook is now clouded by a growing groundswell of risks."

"UK plc has already done the hard yards in terms of restarting business investment, helping drive the economic recovery."

## Business implications in summary

Businesses should keep a close watch on developments throughout the global economy and ensure they have their contingency plans for business critical risks close to hand – and up to date.

The UK economic recovery is continuing unabated. Indeed, despite the consistent failure of exports to grow as expected, the recent revisions to the Office for National Statistics figures suggest overall growth since 2008 has been stronger than first thought.

But wherever you look in the world – and across all sectors – there are risks and potential shocks that could derail businesses' forecasts. Combine that with the general slowing of the global economy, and it's vital that companies assess their exposures on a continuing basis and adjust their contingency plans accordingly.

However, that shouldn't mean cutting back indiscriminately on capital investment. The ONS's revisions revealed higher investment than previously thought especially in areas such as IT. However more investment is required if UK companies are to catch up on investment foregone in the aftermath of the financial crisis.

UK plc has already done the hard yards in terms of restarting business investment, helping drive the economic recovery. It would be a shame if they lost their nerve now, and stopped investing at the point where the hard-earned benefits are within their grasp.

By **Mark Gregory**, *Chief Economist, EY*

Extracted from *Economics for business, Uncertainty returns – but inflation stays at bay*, UK Economic Forecast, Issue 70, Autumn 2014, Ernst & Young LLP, 2014. ■





# Leveraged finance: powering on

Following a strong 2013, market conditions have continued to improve in 2014.

Despite some bumps in the road, such as the Ukrainian conflict, the collapse of Phones4U, and fears of a global economic slowdown, leveraged debt markets have, overall, remained resilient. With significant pools of capital available from both banks and investors, competition for the right deals is fierce and transactions once considered impossible are now feasible.

The European Leveraged Debt markets are evolving through the growth of high yield and the rise of debt funds, familiar themes to leveraged issuers over the last 12 months. Banks are seeking to address these threats to their traditional dominance; and against this backdrop 2015 promises to be another exciting year for leveraged finance both in Europe and globally.

## Leveraged Loan markets

2014 loan issuance is likely to significantly outstrip 2013 volumes. Total European leveraged loan issuance was €65.1 billion for the first 9 months of 2014 versus €67.2 billion for the whole of 2013<sup>1</sup>. Second quarter issuance hit a post credit-crunch high, at €30.2 billion<sup>2</sup>. While volumes are still well down on the €160 billion plus recorded in 2007, the

markets are moving in the right direction<sup>3</sup>. But these numbers only tell part of the story; M&A activity remains well below 2007/08 levels.

Opportunistic refinancings have been a feature of the market in 2014, as borrowers have looked to reprice transactions. Pricing has come down by c. 50-100bps over the last 12 months, with mid-market companies now accessing leveraged bank financing at margins starting in the high 300's.

A further sign that the market is heating up is the return of dividend recapitalisations, an increasingly common event for sponsor-backed companies during their progress to exit. The growth of the high yield market and debt funds in Europe, traditionally more agnostic about recapitalisations, has also driven banks to revisit their traditional rules of thumb for these types of transactions.

CLO's have returned, providing increased institutional liquidity. Year-to-date issuance of €10.1 billion at the end of September is already ahead of 2013 volume<sup>4</sup>. As the bull market returns, covenant-lite loan issuance continues to increase, with year-to-date volume totalling c. €14.7 billion<sup>5</sup>. For the moment, covenant-lite deals are focused on larger transactions competing with either US markets or the high yield

market. While some believe this will persist, mid-market banks are now evolving to meet the challenge of direct lending funds. Syndication has returned, amortisation requirements are falling and covenant requirements loosening.

After six barren years, 2014 saw second lien debt reappear, driving leverage on certain deals up to 6-7x. An example includes Bureau Van Dijk's pre-placed second lien that took total leverage to c. 7.5x as part of its buyout by EQT.

Cross-border loans are also on the rise. European borrowers with US dollar revenue streams and assets, are seeking out what have historically been more flexible and aggressive funding markets in the US where higher leverage, lower equity contribution and fewer (or no) covenants are all available. BC Partners' acquisition of Mergermarket was a perfect example of a UK based mid-market borrower accessing the US markets. The deal was financed through first and second lien tranches with total senior leverage of c. 4x and total leverage of c. 6x.

High levels of institutional liquidity and stronger bank balance sheets have created a perfect environment in which the leveraged loan markets can rebound. We see more of the same going into 2015: increasing levels of syndication, some





“Our forecast for 2015 is that High Yield will remain a core component of the European Leveraged Debt markets.”

By:

**Greg Moreton**  
Director



**Rob Jones**  
Director



“At the end of September, year-to-date volume was €67.7 billion, very close to the €70.1 billion recorded in 2013.”

compression of pricing, increasing leverage appetite and loosening of terms.

### High Yield Bond market

The European High Yield market has now firmly established itself an alternative source of financing for leveraged transactions. At the end of September, year-to-date volume was €67.7 billion, very close to the €70.1 billion recorded in 2013<sup>6</sup>.

However, the market has had a difficult period following the collapse of UK retailer Phones4U. This, combined with record fund outflows and concerns over the direction of the global economy, led to many investors pulling away from primary deals in the final quarter of the year.

Given this volatility, refinancing and recapitalisations continue to account for the vast majority of High Yield bond issuance, with the loan markets still seen as a better and more stable source of capital for buyouts.

Yield compression was a significant feature of the first half of 2014, with average primary yields touching 5%, in part responsible for some of the push-back from investors in the second half of the year. Whilst yields rose during the second half

of the year, they remain on average lower than in 2013.

In a similar vein to the loan markets, increasing competition has also led to the erosion of investor perceived credit quality, with increased flexibility for issuers to incur debt, pursue acquisitions and dispose of assets; and weaker non-call provisions.

Our forecast for 2015 is that High Yield will remain a core component of the European Leveraged Debt markets. It is difficult to believe that yields will continue to compress much further than we saw in the first half of 2014, but competition to put money to work is still likely to drive looser terms and increased leverage.

### Debt Fund market

It says a lot that the debt fund market this year gets its own slot in the year-end Leveraged Finance round up, rather than being hidden away in the leveraged loan section. EY Capital and Debt Advisory now has relationships with over 60 direct lending funds operating in the European mid-market, with one or two funds being added every month.

Transaction sizes vary from c. £10m to c. £500m, but the common feature is that they compete against banks in the

mid-market in much the same way as the High Yield market at the larger end of the transaction scale.

With significant funds to put to work, direct lending funds provide an alternative source of capital for companies looking for more flexibility than the ‘cookie-cutter’ structures banks have historically offered. That being said, as banks have evolved their appetite for alternative structures, so the funds have had to move pricing to meet this challenge.

Increased liquidity from outside Europe, combined with competition from banks, has resulted in more competitive unitranche yields, with deals now regularly pricing inside L+700bps.

Funds have typically been able to compete successfully with banks, offering fewer covenants with looser headroom and no (or minimal) amortisation. However, the banks are fighting back with an increasing number looking at underwriting 100% TLB structures and reducing covenant packages.

Against this backdrop it will be interesting to see how the debt fund and bank markets continue to evolve in 2015 and how long it will be before the first covenant-lite deal appears in the mid-market. ■


1, 2, 3, 4, 5, 6, *Standard & Poor's Leveraged Commentary & Data (LCD)*, [www.lcdcomps.com](http://www.lcdcomps.com), accessed 20 October 2014

# Investment Grade

## Loan markets

**Investment grade borrowers have been spoilt for choice during 2014, with a sustained supply-demand imbalance in capital exerting significant downward pressure on pricing during the year.**

With domestic lenders experiencing fresh competition from foreign institutions – in many cases returning to markets in which they once competed – lead banks have had to sharpen their pencils and put big-ticket commitments on the table to protect their most valuable client relationships. In the absence of demonstrable M&A-related deal flow, lenders have been taking the initiative to discuss amend and extend (A&E) transactions with key clients. This proactive approach has been driven by banks' desire to be seen to be firmly on the front foot with their most valued clients and, whilst accepting reduced facility pricing, take the benefit of accelerated arrangement fee income and protect key relationships for another five years (or seven in the case of those signing up to now-familiar "+1+1" extension options). Such sustained proactive defensive lending – for want of a better phrase – has continued into the second half of the year and is expected to characterise market activity well into 2015.



"... with the capital markets also in rude health, it remains a very favourable time to execute debt-financed strategic transactions."

## The changing regulatory landscape

2014 has seen major developments in the regulatory landscape. These range from the stress testing of European banks, via implementation of Basel III/CRD IV capital regimes, to the impact of international sanctions on global capital markets. Many market participants cite the widespread application of new capital regulations as responsible for driving the evolution of loan facility fee structures – designed to optimise banks' return on capital in a range of utilisation scenarios.

The emergence of more innovative fee structures has given rise to many new terms with which borrowers have had to familiarise themselves. Beyond the traditional arrangement and commitment fees, there are now multi-stepped utilisation fees, ticking fees, first-draw fees, extension fees, new money arrangement fees, old money arrangement fees, bridging fees – the list of terms goes on. Whilst borrowers could be forgiven for assuming at first glance that the ever-lengthening list of fees is simply a new way for banks to achieve out-sized returns, on closer scrutiny these new structures, when used in the right context, can leave borrowers materially better off. More granular fee structures have enabled banks to agree to significant reductions in headline margins. In turn, those have resulted in lower cash commitment fees actually payable by borrowers on committed, but undrawn, facilities.

## Improved liquidity, increased competition, better terms, lower pricing

2014 saw a material improvement in wholesale liquidity costs for banks. These arose principally from improving economic conditions, affirmation of balance sheet stability through further stress tests and falling default rates. The latest round of European bank stress tests resulted in only a small number of institutions being identified as requiring additional capital, with the capital markets reacting to the results with calm and – in the most part – little change in wholesale funding costs. As we move into 2015, additional regulations including bank ring-fencing and prospective requirements for bank 'bail-in' capital could put upward pressure on wholesale liquidity costs, though the ultimate impact on investment grade borrowers is expected to be minimal.

With improved wholesale liquidity costs and improving economic conditions, the lack of M&A flow has resulted in significant over-supply of credit into the investment grade loans market. This has principally manifested itself in material reductions to headline facility pricing, along with the more creative fee structures highlighted above. High-end investment grade borrowers have seen core 5-year facility pricing fall to below 50bps, with "mid-cap" and lower-grade investment grade names still seeing headline pricing fall into the 50-75bps range. Utilisation fees typically

*continued on page 10* ▶





see actually drawn debt costs 10-40bps higher than headline pricing suggests, but the spectre of ever cheaper debt facilities has certainly caught the attention of many borrowers; 2014 saw a flurry of A&E transactions as borrowers sought to renew facility commitments early and take advantage of the favourable pricing available.

Improvements in liquidity and pricing were not the only feature of the year. Investment grade loan facilities have benefitted from increasing flexibility of operating covenants and terms, as lenders have battled to retain existing core relationships. Beneficial movement in leverage and interest cover covenants for some borrowers have been taken one step further by larger names – with some succeeding in removing one or more covenants completely. Whilst typically the domain of only the very largest investment grade names, ‘covenant-lite’ facilities are now percolating further down the investment grade layers – in similar fashion to the upper echelons of the leveraged loan markets. Whether lenders regain the upper hand in covenant negotiations during 2015 remains to be seen, but in the absence of a significant increase in M&A requirements, competition for mandates is likely to dominate lender concessions for the foreseeable future.

## Outlook for 2015

Investment grade borrowers have arguably never had it better. For those looking to undertake material M&A transactions and increase existing debt facilities, 2015 looks like fertile ground for executing new loan packages. Competition between lenders will allow borrowers to negotiate significant flexibility and beneficial terms; even where jumbo bridge facilities are required for M&A purposes. Whilst banks will be keen to ensure bridge facilities are refinanced in the capital markets without undue delay, borrowers can take advantage of this and structure fees and pricing that result in significant mutual economic benefits for both borrowers and lenders in the event of the ‘quick take-out’. Banks remain understandably wary of bridging commitments that end up delayed or, worse still, crystallise into a longer-term funding commitment. However, with the capital markets also in rude health, it remains a very favourable time to execute debt-financed strategic transactions.

As benchmark bond yields increase – as is expected through 2015 with the end of quantitative easing programmes in the UK and US – it is likely that the loan markets and long-term debt capital markets will still present an attractive source of capital for investment grade borrowers. Eurozone growth issues may result in economic stimulus activities being sustained for some time yet, in turn ensuring benchmark rates remain suppressed and presenting European borrowers with continued record-low debt funding costs. This is seen as a likely catalyst for increased M&A debt financing, particularly in those sectors where consolidation plays remain at the forefront of market activity. For those companies looking to put in place financing as a platform for growth, we would expect 2015 to present very favourable opportunities for securing that financing at a cost which presents compelling value to shareholders.

By:

**Michael  
McCartney**  
Assistant  
Director



“Investment grade borrowers have arguably never had it better. For those looking to undertake material M&A transactions and increase existing debt facilities, 2015 looks like fertile ground for executing new loan packages.”

# Bond markets

**The first half of 2014 saw investment grade public bond markets continue their strong momentum with issuers flooding the European market in the final quarter.**

The continuance of low spreads and low government yields combined to maintain close to record low fixed coupon levels for high credit quality issuers. Risk aversion from the sluggish global economic recovery, combining with substantial new political risks such as Russia and Ukraine, Syria, Islamic State, Chinese tensions in Hong Kong - of particular concern to Asian markets - and the Ebola crisis, have driven demand for low risk government debt.

In the Sterling market, investment grade corporate issuance ran ahead of 2013 levels for much of 2014. However, a very slow September, partially owing to the Scottish independence referendum, has left volumes down versus 2013 and well below 2012 levels. Global equity markets witnessed heavy falls in September, before staging a modest recovery, though oil prices suffered a more notable fate during the fourth quarter as OPEC failed to strike a consensus on production levels. Mixed economic signals through the autumn ensured that benchmark US Treasury and Gilts yields reversed gains achieved in 2013 and early 2014, ending the year moving back ever closer towards record lows. Volumes have been notably affected by a slump in demand from 'natural' users of this market, e.g. UK utilities, finding themselves in cyclical lows for their funding strategies (as a result of regulatory review periods), and the cross-currency basis looking unattractive to many foreign issuers. However, there has been a strong flow of new issuance from high-grade sectors such as housing associations and sovereigns. Notable transactions for the year included debut Sterling offerings from the States of Jersey and the States of Guernsey, however the general theme is one of continuing over-liquidity. This has been especially true at the longer end of the curve in Sterling, with the bond markets having a seemingly insatiable appetite for low risk assets, further impacted by the systemic shift of corporates altering their mix of funding from bank to bond market funding.

Both US Dollar and Euro investment grade public bond markets have been very strong all year, with the pricing achieved by debut issuers such as China Gold (US Dollars) and Babcock (Euro's) exemplifying extremely well-timed transactions. That said, nowhere has felt the continued tightening of bank market pricing for investment grade credits more than the US private placement market. After a very slow start to 2014, the US private placement market entered the summer over 30% down on volume for the year. Issuance volumes slowly increased and a bumper September, with a series of issues by mainstream UK plc's including Cobham,

By:

**Luke Reeve**  
Partner



Capita, Compass and Smith & Nephew, has contributed annual volumes for 2014 that have edged fractionally ahead of 2013, which itself was the second largest year on record. The case for mid-caps using the US private placement market as a source of longer-dated, fixed-rating funding remains firmly in evidence. Diversification, without the need for currency swaps or public credit ratings, has continued to see corporates follow the large cap trend of adjusting their funding mix away from a perceived historical over-dependence on bank financing.

In the UK, the social housing and university sectors have begun to find liquidity from US institutions as well as from the small number of UK institutions that have supported these sectors for a decade. The ability to delay funding to match development capex has provided a competitive advantage over some other funding solutions. Whilst 2014 is likely to finish as a strong year overall for issuance in the US private placement market, it is worth noting that most investor appetite for the asset class extends to \$100-125 billion per annum. That means the trend of investor demand exceeding supply continues, highlighting the competition between investors for transactions - a trend likely to continue into 2015 and beyond.

**"Nowhere has felt the continued tightening of bank market pricing for larger investment grade credits more than the US private placement market."**

2014 saw continued activity in the gradual evolution of a European private placement market centered around French investors, with a variety of workstreams aimed at standardising both documentation and process, driven by entities such as the Loan Market Association and Banque de France. Since 2012, this market has priced over €8bn of transactions in both loan and bond, listed and unlisted formats. In conjunction with continued usage of the German Schuldschein market by both traditional Mittelstand and large, cross-border issuers, the non-bank financing options for companies requiring Euros have never been greater.

# Volatility and uncertainty push hedging to the fore

**At the start of 2014, nearly every market commentator was forecasting that government bond yields and swap rates would gradually rise over the course of the year.**

Looking back at some of those forecasts (and those from some of the less bullish commentators) 10yr UK gilts were expected to finish the year at 2.80%. At the time of writing our screens show the 10yr gilt yielding 2.04%<sup>1</sup>. That is pretty low. However, for really low yields we need to look further afield. And our search takes us not to Japan as might be expected, but to the industrial powerhouse of Europe: German 5yr Bunds are yielding just 0.12%<sup>2</sup> which is the same as 5yr Japanese government bonds.

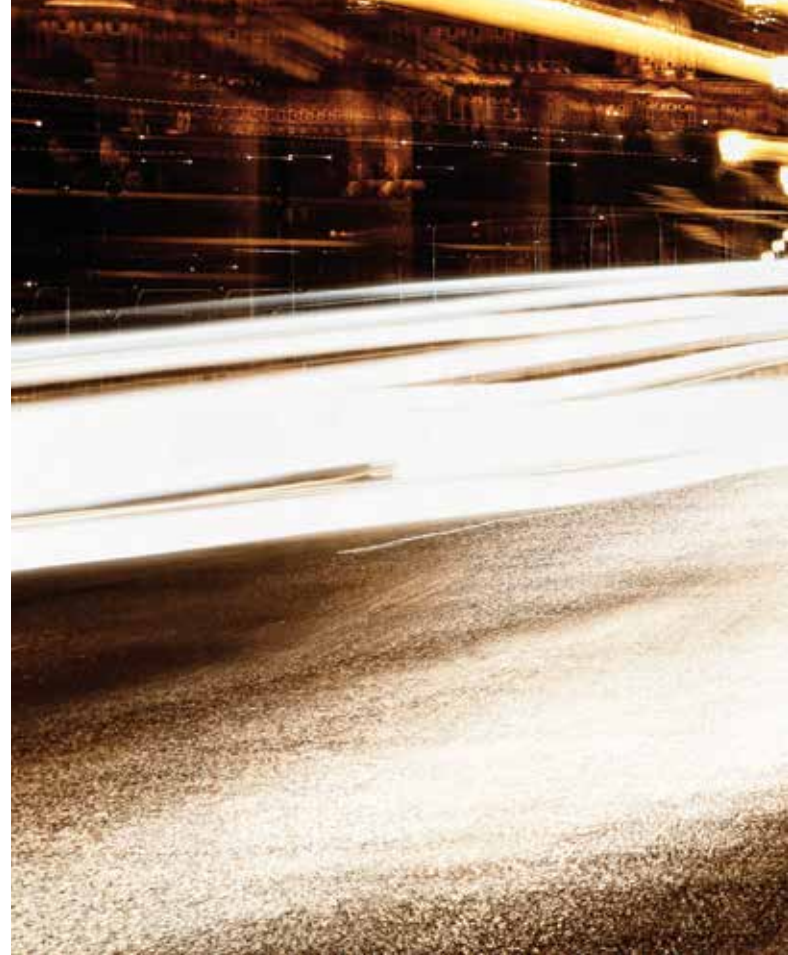
Markets are concerned about slowing global growth. In particular, the IMF's World Economic Outlook has cut its forecast for global growth again, and warned of the risk of recession in Europe.

By:

**Stuart Mackinlay**  
Executive Director

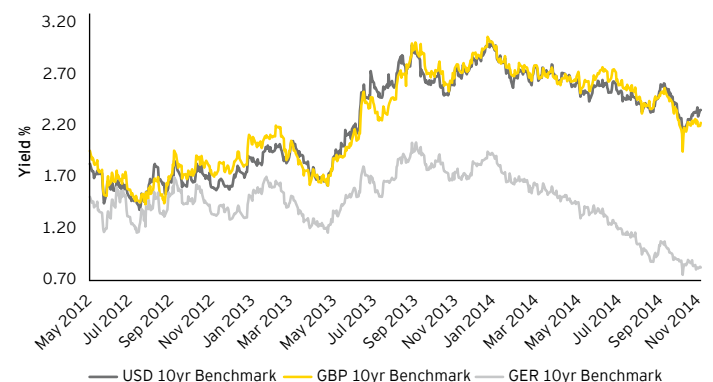


**Rhona Herbert**  
Assistant Director



The volatility in equity markets and disinflation worries have compounded the fear factor, and government bonds benefitted from a flight to safety which drove yields and swap rates even lower.

**The divergence of German government bond yields to those of the US and UK is quite stark; reflecting the continued economic difficulties in the Euro Zone**



Source: Bloomberg

For our clients taking out new bank debt for which they are required to hedge, or for prospective issuers in the debt capital markets, government bond yields and low investor spreads have combined to create potentially very favourable issuing or hedging conditions.

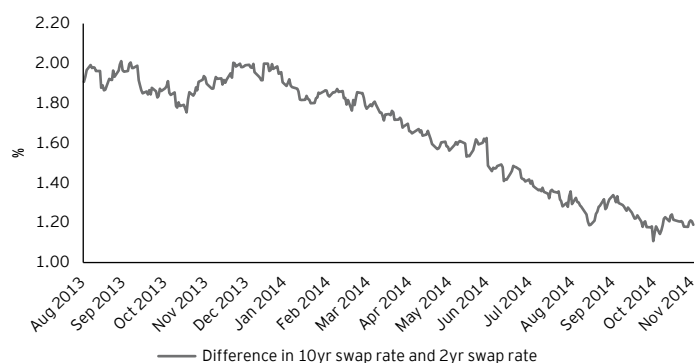
The other interesting feature of this market is how much yield curves have flattened; a theme we have discussed many times in our weekly *Swap market snapshot*.





“Looking forward to 2015, many forecasters expect the UK and US to be the first to raise base rates.”

**Short term rates have remained fairly constant while long term rates have fallen as markets react to reduced growth**



Source: Bloomberg

A flattening yield curve makes forward starting hedges look materially more attractive than they did earlier in the year. While forecasting the direction of interest rates in the short term is relatively safe, the further into the future we try to look, the less certain we are of the future direction of rates.

Therefore, potential borrowers or issuers may want to consider trapping today's market rates for proposed debt two or three years ahead. This avoids any immediate cost of the swap rate being higher than current LIBOR and also avoids the risk of waiting for existing hedging to mature before entering into new hedging.

However, the downside with such a low rate environment is that the break cost on legacy interest rate hedging just doesn't seem to reduce. This is a worry, too, for banks. As rates fall, the cost of keeping these high fixed-rate transactions on their balance sheets is high as they tie up increasing amounts of scarce capital. 2014 has therefore seen us busy advising clients on how best to

manage these break costs and negotiate with the banks. There are a number of alternatives to simply breaking the hedges early and we have enjoyed considerable success with clients who have negotiated discounts to break costs. Clients have been extremely reticent to break legacy hedging now at what they feel is the low of the cycle. But there are a number of ways to address this issue without incurring the entire break cost, a theme we expect to continue discussing in 2015.

Looking forward to 2015, many forecasters expect the UK and US to be the first to raise benchmark interest rates. The performance of these two economies is in marked contrast to those in Europe. We're likely to see questions and uncertainty about the ending of QE within the UK and US, versus the potential launch of such programmes within Europe, coming to the fore. In addition to this will be the associated impact on rate expectations, and the volatility that may be created by escalating global political developments and other macro-events. However, one thing we can be sure of is that we do not expect a change in the importance or value of the income derived from hedging for banks. Consequently, we also expect hedging to remain an important tool in borrower and funder relationships.

As a closing note, it is important to remember that the banks are not allowed to advise on the creation of a hedging strategy, only its execution. At EY we provide our clients with truly independent advice from a team with deep derivatives experience gained in investment banks. This means we can help clients create the most appropriate and flexible hedging strategy for their specific needs. This is important in a market that has seen such a change in views about the direction of interest rates because often the most flexible or appropriate product may not be the one that the banks show first. ■

1, 2 Bloomberg, [www.bloomberg.com](http://www.bloomberg.com), accessed 25 November 2014

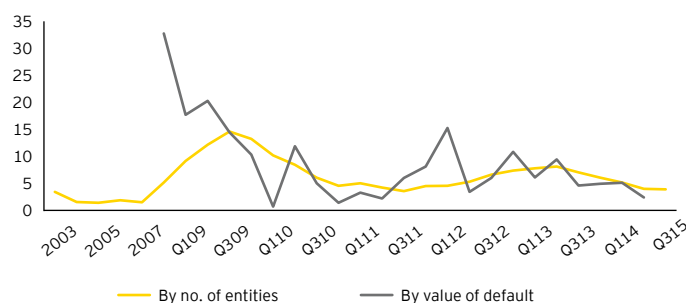
# Default rates are falling for speculative grade companies



**Looser credit conditions and lower corporate bond yields underpinned a surge of investment into high yield over 2014. But this was not a foolhardy rush: high yield default rates are low and should remain that way.**

Default rates for European speculative grade (BB+ and below) companies have been falling since their peak in 2008/09. Unless there is an unforeseen reversal of fortunes in the European economy (something worse than the predicted very sluggish growth), this trend should continue. S&P's 4Q14 default statistics show a year-on-year fall in the 12 month trailing average to 4% from 5.1%, with a 2015 forecast fall to 3.9%.

## European speculative-grade default rate



Source: S&P, *European Corporate Default And Recovery Rates Should Continue To Improve Further In 2015*, 7 Oct 2014

European trends underpinning this improvement in non-investment grade credit are: a weaker Euro (underpinned by continuing low rates) boosting exports; higher consumer disposal incomes as austerity tails off and better banking conditions prompting a recovery in willingness to lend.

**"But there has also always been a downward bias in ratings: it's easy to fall, but hard to rise."**

By:

**Anton  
Krawchenko**  
Director



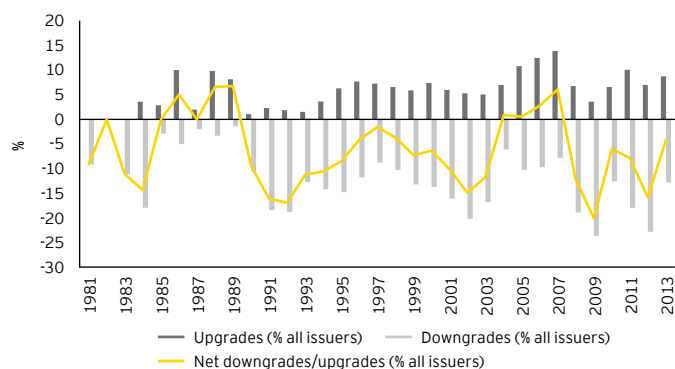
## Globally ratings are not improving, but there is real upgrade potential for the right companies

In the 33 years since 1981, S&P only upgraded more companies than it downgraded seven times. This downward bias partly reflects the cycle of birth and death among many speculative grade issuers (i.e., initial ratings moving in only one direction: down towards default).

But there has also always been a downward bias in ratings: it's easy to fall, but hard to rise.

Only during rare economic booms (the late 1980s and mid-2000s) have there been more upgrades than downgrades (illustrated below).

### Long-term trend in upgrades versus downgrades



Source: S&P, 2013 Annual European Corporate default Study and rating Transition, 8 April 2014

Given the slow or moderate medium growth outlook for most large economies, we do not expect any general, across-the-board uplift of average ratings. Yet against this global view it's important not to lose sight of the upgrade potential for well-positioned companies in recovering national economies (e.g., the UK).

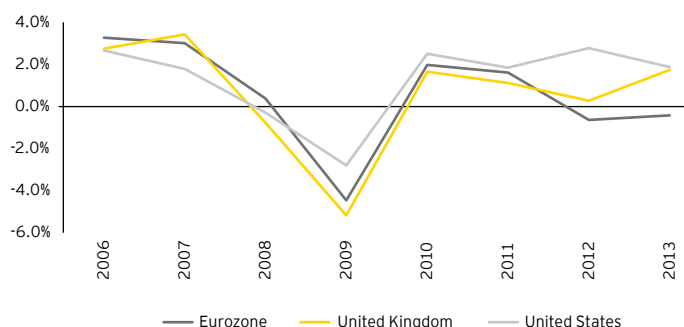
Agencies have gone through a cycle of deep conservatism in ratings to correct for four consecutive years of net upgrades just before the credit crisis (which somewhat undermines agency claims that they rate 'through the cycle'). For the right companies in the right markets, we believe agencies are now (finally) truly open to upgrades, despite the global net downgrade trend.

## Credit trends will diverge, along with the global economy

Several years ago, we would have expected growth rates amongst the large western economies to converge coming out of the credit crisis: growing at different rates, but converging nonetheless.

This is indeed the trend we saw moving into 2010 (illustrated below).

### Historic GDP growth rates (%)



Source: The World Bank, Economy & growth Indicators, GDP growth (annual %)

So what happened? The global growth story since then has been one of divergence. We have seen this reflected in credit differentiation between rated corporates, and it's a trend of credit divergence that looks set to continue.

S&P forecasts 2015 GDP growth of 3% and 2.5% in the US and UK, respectively, against 1.5% in the Eurozone. These growth trends compound differences in national wealth and the 'break even' point for economies coming out of the credit crisis.

Real GDP in the US has increased by a cumulative 11.5% since 2Q09. Real GDP is now 6.8% above its pre-crisis peak.

In the Eurozone, real GDP has only increased by 3.5% since its lowest point, and real GDP is still 2.4% below its pre-crisis peak level. Italy and Spain are still 6.4% below pre-crisis peak GDP levels, respectively.

Such is the strength and persistence of this economic trend of divergence that we expect it to be reflected in ratings trends for years to come. ■

### Article sources:

S&P, *Economic Research: A Parting Of The Ways In The Global Economy*  
S&P, *European Corporate Credit Outlook Q3, 2014*



# UK secured real estate lending

## Competition heating up

### **2014 has been a good year for the UK economy as a whole, and for UK real estate in particular.**

Since late 2013, property values have increased substantially, and are now 16.5% above their 2007 peak. Over the same period, there has been a marked increase in the availability of debt, driven by a combination of factors including continued government intervention, lower wholesale funding costs and increased competition from non-bank lenders.

While these conditions might understandably trigger a faint sense of déjà vu, the difference this time around would appear to be that the market, and hence values, are largely being driven by equity searching for yield, rather than the availability of cheap debt.

### **The changing landscape**

Prior to the credit crisis, c.95% of all UK real estate finance was provided by banks. Research published by De Montfort University suggests that, while banks remain the most significant providers of real estate finance in the UK, non-bank lenders accounted for c.25% of all new loans originated in 2013 compared with c.15% in 2012.

The most active bank lenders in the UK market include the UK clearers, together with a number of German banks and US iBanks, which increasingly have both the ability and appetite to underwrite large single tickets and hold substantial exposures on balance sheet.

In the first half of 2014 alone, closings of debt funds targeting Europe accounted for c.50% of all equity raised globally in that period.

Increased bank appetite, coupled with the dramatic increase in the availability of non-bank debt – comprising both insurance companies and debt funds – has seen power shift back to well capitalised borrowers. They are increasingly spoilt for choice and are able to access competitively priced debt for a range of gearing levels (up to c.85% LTV) and loan tenures (anything from 6 months to 25 years).

The longer term fixed-price financing being offered by insurance companies has undoubtedly allowed long-term strategic investors to capitalise on historically low gilt rates. However, the most significant change is arguably the return of the syndication market and the arrival of whole-loan debt providers able to write large single tickets (>£100m), and then sell down either vertical, or horizontal tranches in the secondary market.

Whilst there are still capacity constraints for loans in excess of c.£100m, these can be overcome by assembling a club of banks of non-bank lenders.

### **Pricing**


In the UK, senior loan margins on prime commercial real estate have tightened from c.250-300 bps in 2013 to c.125-200 bps currently. For similar assets, the cost of mezzanine finance has reduced from low double digits, to high single digits.

As lender appetite to buy into syndications increases, so too does the appeal of whole loan providers able to write large single loans at competitive all-in margins (below 300bps for 75% LTV on prime commercial real estate).

At the same time, the European CMBS market is re-emerging. The recent Westfield Stratford City Finance issue (which priced at an all-in cost of c.101bps over 3M-Libor for 38.4% LTV) was the first time since the credit crisis that a CMBS issue has priced inside the banking market for prime UK commercial real estate.

The question that then arises is how much further bank margins can realistically tighten, before increased regulatory costs start to cannibalise banks' returns. By comparison, CMBS spreads are expected to tighten further and CMBS issuances grow, as more borrowers are attracted to the potential cost savings CMBS offer. For the time being, however, CMBS issuances account for a relatively small proportion of the real estate finance market.

Average margins for financeable secondary commercial real estate have also tightened as a result of competition at the prime end forcing a number of lenders to take another look at secondary assets, with margins currently ranging anywhere between 250-400 bps.



**"Since late 2013, property values have increased substantially, and are now 16.5% above their 2007 peak."**

## Development finance

Lender appetite to provide development finance for residential-led schemes has rebounded strongly, with a number of bank and non-bank lenders active. By comparison, there are still very few lenders providing commercial development finance which, when available, is typically subject to a minimum level of pre-lets.

Whilst the level of development finance being originated remains c.50% below its 2007 peak, increased competition to fund the best development schemes has resulted in a significant tightening of margins. It is therefore increasingly common to see conventional senior debt for residential developments (<65% LTC) price comfortably below 300bps.

As with commercial investment finance, developers in the UK have increasing access to competitively priced debt for a range of gearing levels (up to c.100% LTC), asset classes and geographies.

## Where to from here?

Although interest rates are expected to remain at current levels for the remainder of 2014, a rate increase in early to mid 2015 looks increasingly likely. As such, the key question remains what impact an increase in rates will have on UK economic recovery.

In the meantime, we will continue to support our clients as they navigate the ever-changing UK real estate finance landscape, in order to help them take advantage of increased competition and to ensure that the finance they raise aligns with their strategic objectives and appetite for risk. ■

**By:**

**Dharmi Morjaria**  
Assistant  
Director



# Regional debt markets

## 2015: Positive trends continue, with risks on the horizon

For EY's regional and SME focused team, 2014 continued 2013's trends: increasing funding sources and liquidity through confident and emerging challenger banks, asset-backed lenders and debt funds. 2014 also saw new complementary trends, including increasing debt structure innovation, changes in borrower requirements and decreasing margins. We explore these, and their implications for borrowers, further in this article.

### Debt structure innovation

Capital innovation has been led by the rise of debt funds. These funds often work in smaller teams, with clear return and risk mandates. Provided a transaction meets their mandate, funds can structure their deals relatively flexibly, for example using cash or non-cash paid interest, equity-like warrants versus high interest coupons right through to medium or very long-dated term.

Whilst this innovation clearly benefits regional companies, one key challenge we have seen during 2014, and expect to continue in 2015, is a lack of funds focusing on the sub £10m borrowing requirement. Though several new debt funds have entered this space in 2014, these tend to focus on higher cost of capital solutions, often more suited to a borrower requiring a change of control or with a transformational funding objective to justify the potential cost.

Outside of the sub £10m borrowing space, a key challenge for debt funds continues to arise from the relatively new precedence of their structures and what this means where debt fund capital is used to fund borrowers alongside more traditional bank funding, such as asset-backed lending lines. This lack of precedence in all but the super senior RCF intercreditor structures continues, and from the outset requires proactive management from all parties working towards a suitable solution.

Where funds can totally replace traditional funders, however, or restrict debt capital into separate funding vehicles, regional

borrowers can – and have – experienced significant capital inflows from debt funds in 2014.

### Borrowers' requirements

Our second noted trend was changes in borrowers' requirements. 2014 saw us work with regional corporates to expand and restructure existing facilities to support accelerating growth and sales agendas. Organic growth led the charge in the first part of the year for our clients, however we expect that in 2015 regional corporates' are likely to seek debt financing for inorganic acquisitions, a trend supported by significant acquisition pipelines.

Stressed-led financing agendas were less evident for our regional corporates in 2014. However, where we did work with companies, these deals focused on refinancing legacy leverage transactions. In cases like these, debt capacity based on historical (pre-recession) trading volumes had led to over-leverage and an inability to refinance until underlying trading had returned to financeable levels. Thankfully, a return to historic or at least stable trading levels coupled with increasing lending appetite and liquidity, is now allowing these previously trapped companies to seek refinancing.

### Decreasing margins

The final trend is the changes in margin seen across the spectrum. For SMEs seeking a lower cost of capital, 2014 has been a positive year. 2014 saw a fall in the average UK SME margin, which at the time of writing is nearly 10% lower than at the start of 2013<sup>1</sup>. Whilst diverse drivers are lowering the cost of capital, some of the major influences include:

- Government intervention via lending targets: the British Business Bank and Funding for Lending continue to pressure funders to service the SME marketplace
- A diversifying funder set is creating competitive tension, particularly from funders that are not exposed to either Basel regulation or political pressures

- The perception of risk attached to the mainstream funders. For example, five year CDS spreads fell on average by 36% during the year for Barclays, RBS and Lloyds<sup>2</sup>, meaning their internal cost of capital has generally fallen and can be passed on to borrowers, and finally;
- The improving performance and GDP growth of UK and US economies.

We have selected some of these positive trends supporting the lowering cost of capital so that we can also highlight the variable nature of many of the key drivers. These include for example, Funding for Lending potentially ending in 2015, the re-privatisation agenda of several UK banks, the reducing of quantitative easing and possible base rate increases.

In summary, 2014 continued to provide a positive environment for SMEs to capitalise on the increasing liquidity, innovation and falling cost of capital on offer. This could change, however, as new funders lack precedence, global political and economic conditions are not yet stable and the cost of capital could well prove volatile. As such, our message remains relatively simple: regional companies should continue to own and run their debt financing strategies and agendas proactively to ensure they understand potential cost savings and sources of additional capital available today versus the potential risks in securing attractive funds tomorrow. ■

#### By:

**Gary Davison**  
Partner



**Jashen Josson**  
Assistant Director



1 Bank of England, *Trends in Lending*, October 2014

2 Reuters, [www.reuters.com](http://www.reuters.com), accessed 7 November 2014



# Sector moves to centre stage

At the tail end of 2008 and into 2009 the markets seemed to be typified by the successive rescue of one financial institution after another. Five years on from the credit crisis and the availability of different types and structures of loans for corporate borrowers has never been so great. The question now is how to navigate these new lender pools (and those pools covered elsewhere in Credit Markets) and put the lending arrangements in place that will best fit each corporate's strategy.

Responding to that question requires consideration of a number of interdependent drivers. These cover basic financial and economic fundamentals, regulation, markets, technology, politics and so on. But more than ever before, the increasingly critical consideration is the sector in which a corporate operates.

Understanding and being able to see both current sector dynamics and those likely to bite during the life of the loan are key. Perhaps even more important, however,

are the sector trends which are likely to develop after the life of the loan. These will have an impact on the borrower's performance and therefore determine the likely prospects for refinancing the current loan.

As an advisory team, we have never devoted so much time to mining deep sector content and insights to support the analysis behind the appropriateness of a given debt structure. Put bluntly, the sector helps sell the credit story. There are many debt funds, for example, that may be lending into a given sector for the first time. Supporting and responding to their emerging questions about sectoral strength and developments are key. Simply being helpful to the prospective lender by soft supporting their credit analysis can also prove to be extremely beneficial.

From a debt advisory perspective, our model is now at its most effective where the borrower remains principal at all times, taking the appropriate debt structure "ask"

to market, and going in with a clear and organised approach – typically including a process letter and term sheet with a credit presentation. However, a presentation enhanced with sector-rich content can increase the momentum behind a transaction and, with that, secure a more certain outcome.

The growing diversity of credit pools and markets changing more than ever, make sector insight and application more important than they have ever been. And that's a trend we certainly expect to continue into 2015. ■

By:

**Chris Lowe**  
Partner



"Understanding and being able to see both current sector dynamics and those likely to bite during the life of the loan are key."

# Asset-based lending

**Asset-based lending (ABL) is a form of secured lending whereby funds are advanced based on the value of the borrower's assets.**

The difference from traditional, commercial bank finance lies in where the lender looks for repayment of the loan. Banks focus on a would-be borrower's cash flow as a means of securing repayments. Asset-based lenders concentrate on a company's collateral.

Assets can include a wide variety such as accounts receivable, stock, real estate and, occasionally, intellectual property rights. Lenders establish a revolving line of credit (revolver) for a maximum amount. By establishing a security interest in its receivables, the borrower in effect creates a borrowing base for the loan. The size of the borrowing base alters in line with the fluctuations in the borrower's assets, limited to the overall line of credit.

Importantly, ABL is not just a facility for those corporates shunned by traditional banks; it offers distinct advantages. ABL is characterised by revolving facilities and preserves more cash than traditional bank loans burdened with amortisation requirements. Additionally, the structure often requires fewer covenants, and so provides many borrowers with more flexibility.

## **Keen pricing**

One of ABL's key benefits in 2014 has been its competitive pricing. In our experience the interest cost of an asset-based loan can be significantly less than a traditional bank loan (anywhere between 100 and 200 basis points). As lenders are advancing against a company's most liquid assets that have a readily identifiable value, their ultimate credit risk is lower. This reduced risk is recognised by the banks, with ABLs sitting to some extent beyond the gaze of some of the most onerous regulatory demands and certainly recognised as an efficient form of lending from the perspective of regulatory capital allocation.

In 2014, a comprehensive ABL facility has been the ideal solution for many corporates coming out of the recession. Businesses that have deleveraged and postponed investment, because of tighter working capital requirements, need flexible and supportive finance structures that allow them to emerge from the downturn.

**"Assets can include a wide variety such as accounts receivable, stock, real estate and, occasionally, intellectual property rights."**

"The competitive market seen in 2014 will continue in 2015, with ABL and alternative capital providers such as debt funds competing."

## Growing UK and European volumes

ABL has long been a key feature of the US loan landscape. According to Thomson Reuters, ABL volume was almost \$83bn in 2013, the second highest annual volume total on record. However, Europe and the UK are catching up. The three months to 30 June 2014 was the biggest ever quarter for asset-based finance, with a record £18.9 billion of funding provided to businesses, says the Asset Based Finance Association (ABFA). According to figures from the ABFA, the combined amount of invoice finance and asset-based lending provided to businesses leapt by seven per cent in the last quarter, from £17.7 billion in March 2014, and 10 per cent in the last year, from £17.3 billion in June 2013. By Q2 of 2014, the total number of businesses in the UK using ABL stood at 43,462.

At sector level, manufacturing is often cited as an industry ideally placed to benefit from ABL, alongside sectors such as distribution and support services. According to the latest ABFA figures, of the clients making use of ABL in June 2014, 12,915 were in the service sector, 12,651 in manufacturing, and 10,742 in distribution.

Average deal sizes have increased through 2014, with average deal size in June 2014 up 9% from the same period last year. According to ABFA almost a third of the total advanced through asset-based finance was used by companies with an annual turnover of more than £100million. Furthermore this trend is also evidenced in the growing use of ABL by groups with Pan-European operations and alongside hybrid structures. ABL is now appropriate for a range of companies, from mid-market through to large corporations. Even the largest businesses can take advantage, as the facility is linked to underlying business assets, and can grow as a business's working capital needs expand.

ABL also continues to be used in combination with existing and newly issued high-yield bonds. As ABL works well in conjunction with a bond or with mezzanine finance, it is able to compete head-to-head with traditional cash flow based loans.

## Continued expansion in 2015

We believe that ABL will continue to grow through 2015, following the established trends of the US market, with the increasing presence and activity of leading providers from North America acting as a crucial spur to growth. Furthermore, some UK banks are aggressively growing their ABL teams and portfolios in recognition of ABL's comparative efficiency against alternative lending products. The growing number and increasing competition between ABL players are expanding choice, resulting in compelling debt structures and pricing for customers.

The competitive market seen in 2014 will continue in 2015, with ABL and alternative capital providers such as debt funds competing. This will lead to downward pressure on pricing and structural innovation through a variety of 'stretch' facilities; these facilities are being deployed in the form of either an over-advance against collateral or the provision of cash flow strips.

Underlying and supporting ABL growth is greater understanding and acceptance among corporates, private equity and advisers. Asset-based lenders have successfully targeted advisers and private equity through 2014 which has led to an increased number of sponsor deals, albeit often facilitated by some form of bespoke tailoring to the ABL documentation. We expect this upward trend to continue as the market further appreciates the benefits of ABL.

By:

**Richard Williams**  
Director





# Debt facilities for (and as an alternative to) IPOs

**The first half of 2014 saw a major boom in the IPO market. While the pace has since cooled, IPO nonetheless remains a favoured exit route for many leveraged buyouts, as well as companies owned by families or entrepreneurs. Despite the current market conditions, EY continues to work with a large number of such companies, who are slating the first half of 2015 for the launch of their businesses on the public markets.**

By:

**Greg Moreton**  
Director



Preparing for an IPO is a complex business. It requires a large amount of time and support simply to achieve the core objective of the equity launch. A company has to be prepared both financially and legally to meet the rigorous requirements of the stock exchange. However, alongside these imperatives, it's important not to forget the company's debt financing requirements.

As part of their investment rationale, equity investors will expect to see an IPO-ed company geared appropriately for its sector. In mainstream sectors, this typically means leverage of 1.5x-2.0x Net Debt. While banks are often able to lend more, the brake on borrowing typically comes from investor prudence, rather than lack of lending appetite. Relatively low levels of lending are often linked to dividends. If these are required in order for the stock to do well, then low leverage is important, as banks will typically seek to restrict dividends at higher levels of leverage.


The debt deal needs to be ready to be signed at the same time as the IPO. This is so it can be referred to in the listing materials and it becomes part of the 'sell' to investors. The debt process should therefore be undertaken in parallel with the main IPO process. There are essentially two ways to ensure appropriate debt facilities are in place in good time: arrange brand new facilities, or maintain the existing facilities, amended for IPO.

Undertaking a new debt facility is likely to provide the keenest terms for a post-IPO facility. Going straight into the 'corporate' debt market requires additional effort as it means starting with a new group of banks who focus on this market, who may not be the same as those that have lent hitherto on a leveraged basis. The effort should prove worthwhile however, as these banks typically expect both lower returns and looser covenants (for example flat rather than sculpted covenants).

Amending an existing debt facility is likely to be the fastest way to secure an IPO-ready debt facility. Existing leverage lenders are likely to be amenable to amendments to ensure some pricing reduction, and some loosening of leveraged covenants, and this process can be undertaken in relatively short order. However, the nature of the banks/lenders involved means that there will be a limit to their appetite to reduce pricing. Undertaking this process is therefore often followed by a full refinancing after a successful IPO.

In the current climate, it's also sensible to have an alternative to IPO. Running leveraged debt and IPO debt processes simultaneously allows a company to be on the front foot should the IPO fall away. The leveraged debt indications could be converted into a recapitalisation to provide shareholders a partial exit, or into a sell-side debt process to support a sale as an alternative way of achieving a complete exit. ■





"There are essentially two ways to ensure appropriate debt facilities are in place in good time: arrange brand new facilities, or maintain the existing facilities, amended for IPO."

# About Capital & Debt Advisory

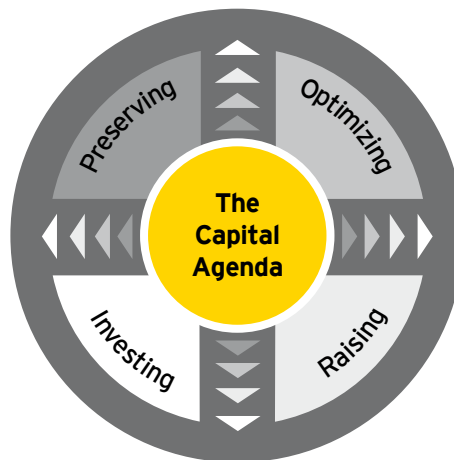
**Our Capital & Debt Advisory (CDA) team forms part of our larger Lead Advisory team, which plays an integral role in our Transaction Advisory Services practice.**

CDA was established in 2009 to provide strategic, objective and robust advice to clients across all aspects of their capital structure and financing strategy. Since then we have grown to 70 advisers globally, and successfully helped many businesses deliver on their capital objectives.

Our CDA team is experienced in leading complex financings and transactions across a range of sectors and debt products.

Our clients can draw on a talented pool of bankers and financial analysts within CDA, as well as our sector teams across the globe, market data platforms, and expertise from our other service areas within EY including Tax, Assurance and Advisory.

## The Capital Agenda



Our Transaction Advisory Services practice is aligned to the Capital Agenda, which enables us to provide clients with sector focused corporate finance advice throughout their capital life cycle. Our Capital Agenda strategy puts the capital needs of our clients at the heart of what we do and focuses on the issues that matter most. Our market leading knowledge and expertise can help businesses make better and more informed decisions about how to strategically manage their capital and transactions in a changing world.

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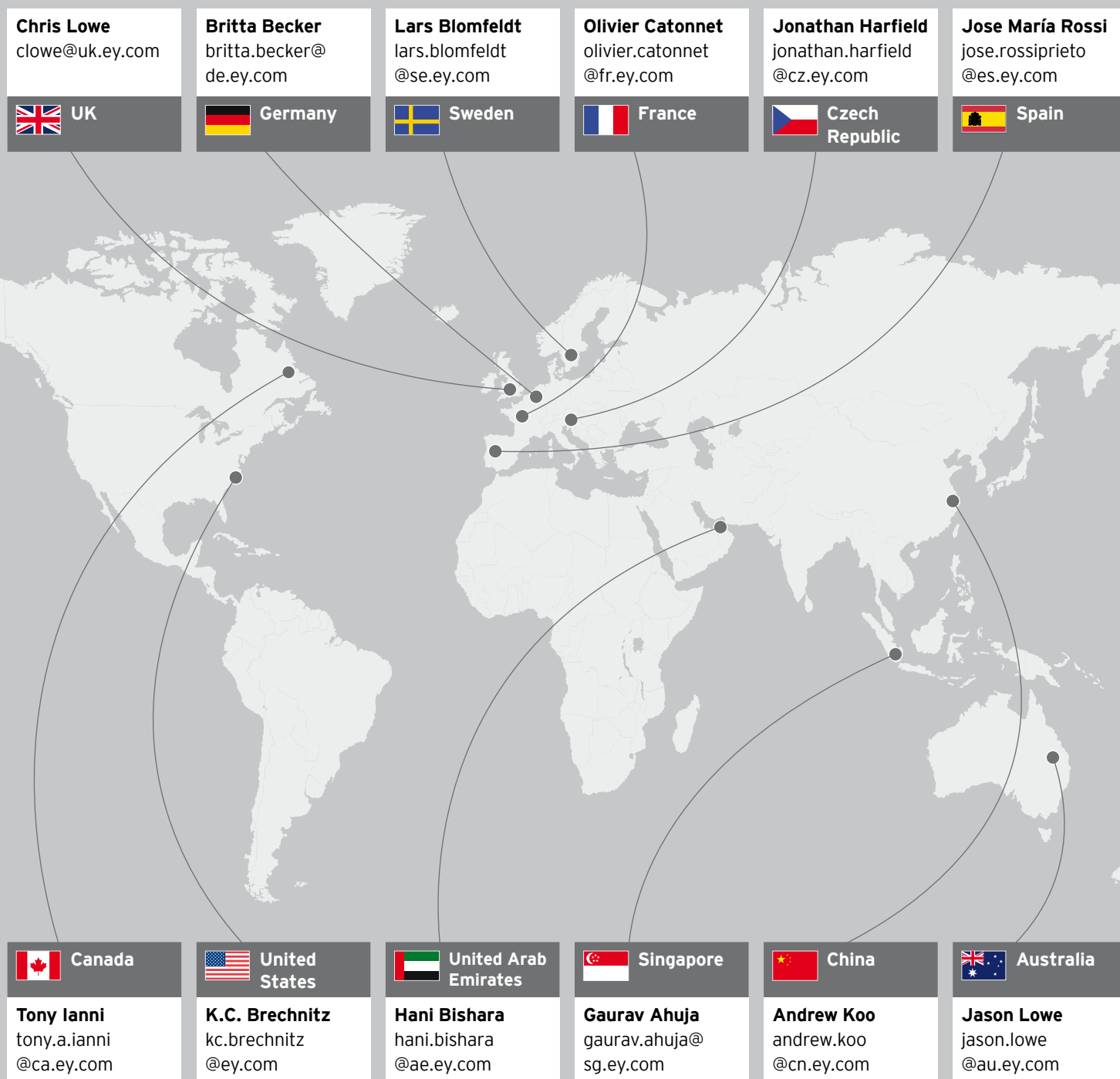
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# Meet your global team

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## Thank you

On behalf of the team at EY, a big thank you for taking the time to look at *Credit Markets*. It's a publication we are proud of and one that we hope you find of value. You have the team contact details opposite, and we are always pleased to meet, chat and share market views – so please do not hesitate to contact us. 2014 saw significant shifts at times in the liquidity and terms achieved from different capital pools and we expect that to continue in 2015 and beyond.

**Chris Lowe**

Partner, EY and Editor of *Credit Markets*

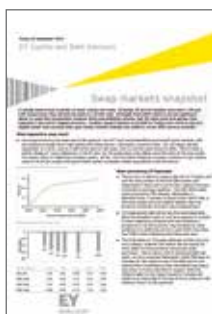
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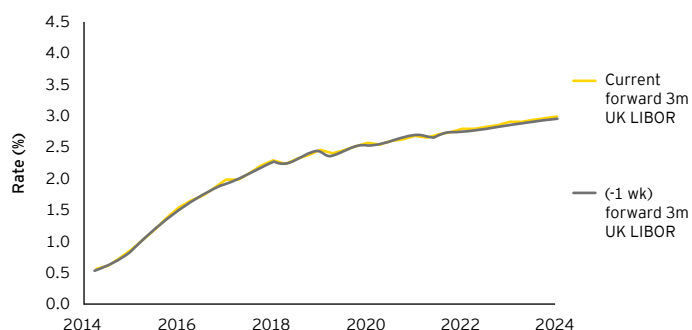




# Data centre



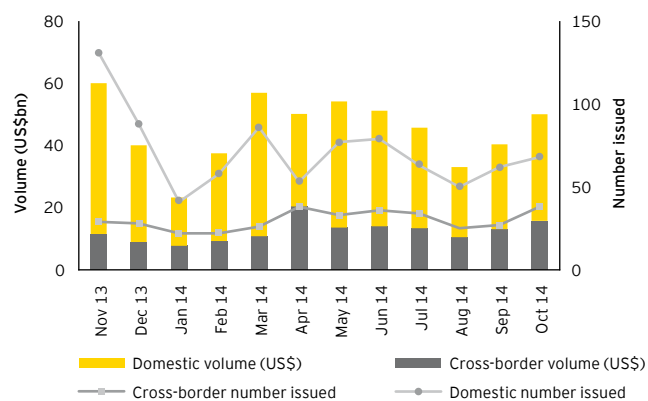
Figure 1 **3 month UK LIBOR forward rates**



Date: as at 31/10/14

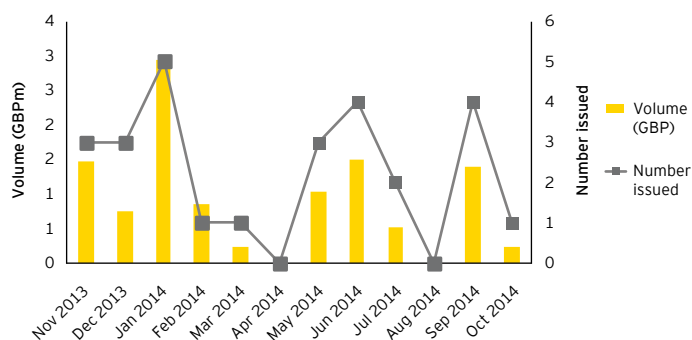
Source: Bloomberg

Figure 3 **Monthly US\$ bond volumes**



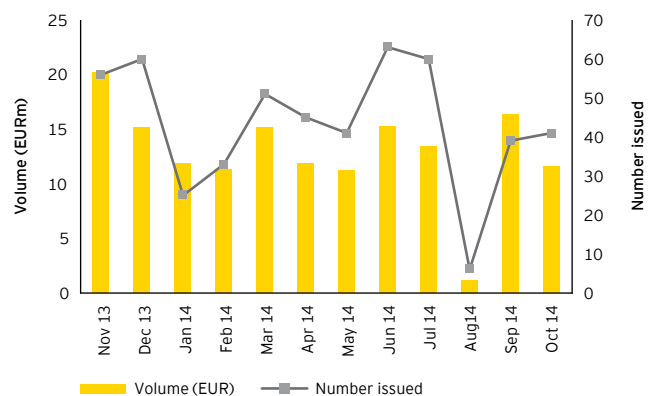
Source: Reuters

Figure 2 **Monthly GBP bond volumes**



Source: Reuters

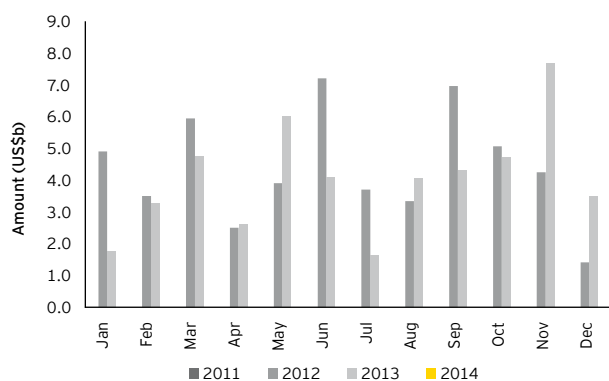
Figure 4 **Monthly EUR bond volumes**



Source: Reuters

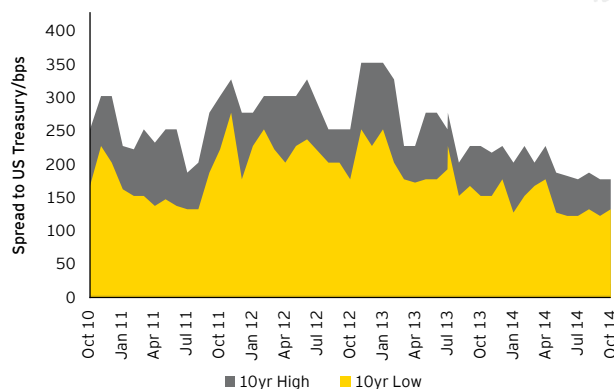


Figure 5 US private placement volumes



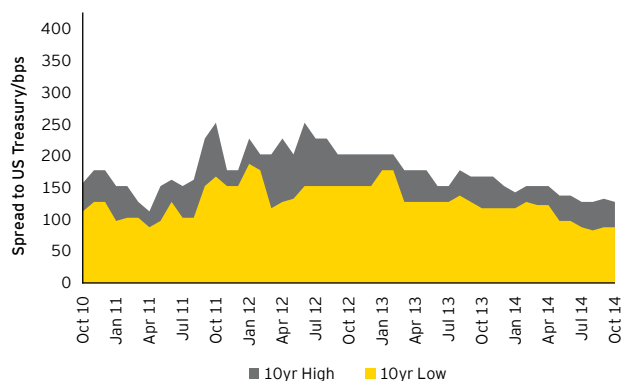
Source: Private Placement Monitor

Figure 7 NAIC-2 US private placement spreads (bps)



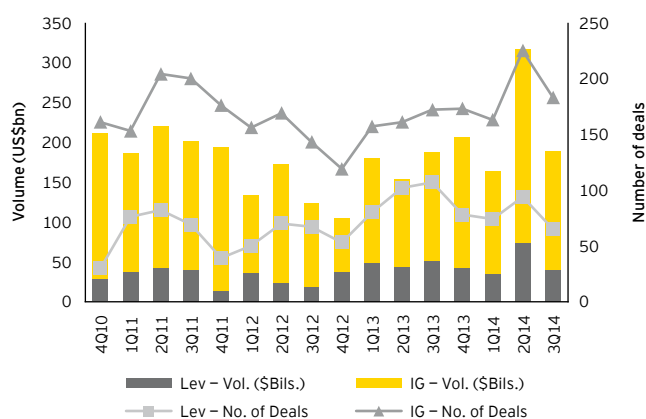
Source: Private Placement Monitor

Figure 6 NAIC-1 US private placement spreads (bps)



Source: Private Placement Monitor

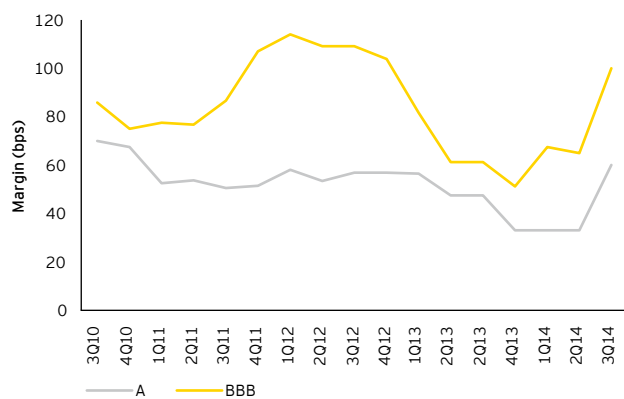
Figure 8 Western Europe loan volumes



Source: Loan Connector

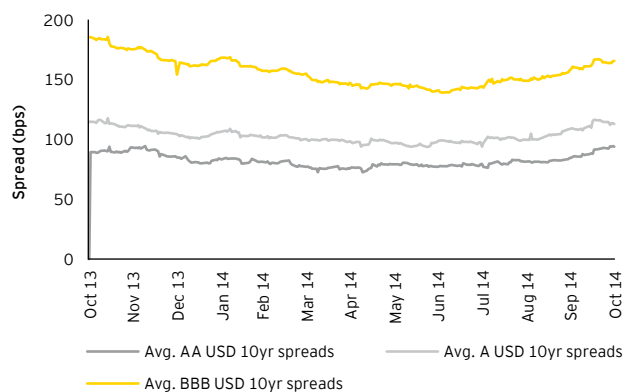
continued on page 30 ►

Figure 9 **European pricing grid – multiyear drawn**



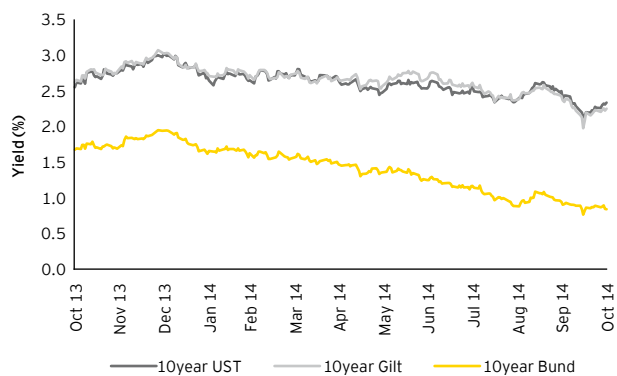
Source: Loan Connector

Figure 11 **USD secondary public bond spread 10-year**



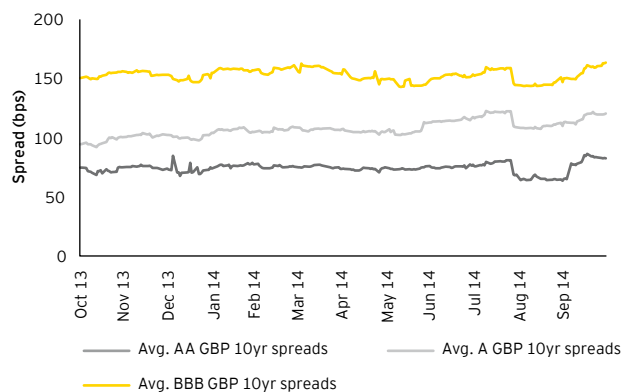
Source: Reuters

Figure 10 **10-year benchmark yields**



Source: Bloomberg

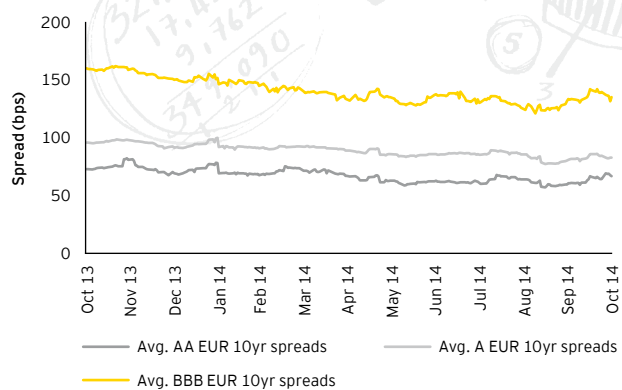
Figure 12 **GBP secondary public bond spread 10-year**



Source: Reuters

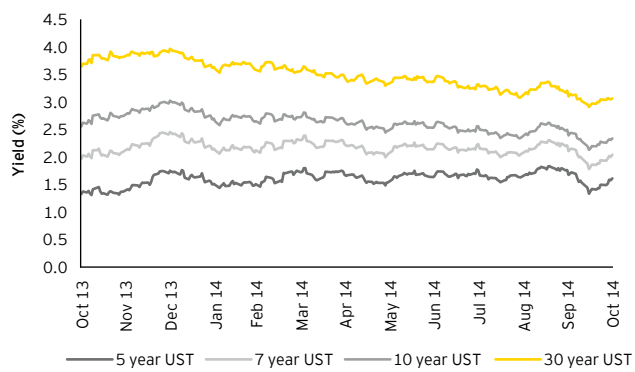


Figure 13 **EUR secondary public bond spread 10-year**



Source: Reuters

Figure 14 **US Treasury benchmark yields**



Source: Bloomberg

# Further insights



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